

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Apple Canyon Utility Company	:	
	:	
Proposed general increase in water rates.	:	
(Tariffs filed October 14, 2009)	:	09-0548
	:	
Lake Wildwood Utilities Corporation	:	09-0549
	:	(Cons.)
Proposed general increase in water rates.	:	
(Tariffs filed October 14, 2009)	:	

PROPOSED ORDER

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By the Commission:

I. INTRODUCTION

A. PROCEDURAL HISTORY

On October 14, 2009, Apple Canyon Utility Company (“Apple Canyon” or “ACUC”) and Lake Wildwood Utilities Corporation (“Lake Wildwood” or “LWUC”), (collectively, the “Companies” or the “Utilities”), separately filed with the Illinois Commerce Commission (the “Commission”) pursuant to Section 9-201 of the Public Utilities Act (the “Act”), 220 ILCS 5/9-201, the following tariff sheets respectively: Ill. C. C. No. 1, 9th Revised Sheet No. 1 and 8th Revised Sheet No. 1.1 and Ill. C. C. No. 2, 2nd Revised Sheet No. 1 and 1st Revised Sheet No. 2 hereinafter referred to as “Filed Rate Schedule Sheets,” in which they propose a general increase in water rates, to be effective November 28, 2009.

This rate filing embodied a general increase in rates for water service as well as other proposed changes in terms and conditions. Notice of the proposed changes reflected in this rate filing was sent to customers, posted in the Companies’ business offices and published in a newspaper of general circulation in their service areas, as evidenced by publisher’s certificates, in accordance with the requirements of Section 9-201(a) of the Act, 220 ILCS 5/9-201(a), and the provisions of 83 Ill. Adm. Code Part 255. The Commission issued an Order on November 12, 2009 suspending the tariffs up to and including March 12, 2010 and initiating this proceeding. Subsequently, the Commission re-suspended the tariffs on February 24, 2010 up to and including September 12, 2010.

Leave to Intervene was granted to Apple Canyon Lake Property Owners’ Association, Inc. (“ACLPOA”) and Lake Wildwood Association, Inc. (“LWA”), (collectively, the “Intervenors” or “Home Owners”).

On February 4, 2010, the Administrative Law Judge granted a Motion to Consolidate filed by the Companies.

The Commission conducted public hearings on February 24, 2010 for Lake Wildwood and on March 2, 2010 for Apple Canyon.

On May 14, 2010, the parties and Commission Staff filed pre-hearing memoranda, in which, they set forth the legal and factual issues that they would present at trial, thus satisfying the Constitutional requisite that notice of the legal and factual issues be presented before trial on those issues commences. Pursuant to notice given in accordance with the law and the rules and regulations of the Commission, this matter was heard by a duly authorized Administrative Law Judge ("ALJ") at the offices of the Commission in Chicago, Illinois. An evidentiary hearing (hereinafter referred to as "trial") was held on May 18, 2010. At the evidentiary hearing, Apple Canyon Utility Company, Lake Wildwood Utilities Corporation, Staff of the Commission, Apple Canyon Lake Property Owners' Association Inc. and Lake Wildwood Association appeared and presented testimony. The record was subsequently marked Heard and Taken.

Apple Canyon Utility Company and Lake Wildwood Utilities Corporation presented the following joint witnesses: Carl Daniel, Regional Vice-President of Utilities, Inc. and several of its subsidiaries including the Companies; and Steven M. Lubertozi, Executive Director of Regulatory Accounting and Affairs for Utilities, Inc. and its subsidiaries. Paul D. Burris, who had been Regional Vice President for the Midwestern and Western Regions of Utilities, Inc. at the time that this case was filed, also submitted testimony.

The following witnesses testified on behalf of Staff: Philip Rukosuvb, a Rates Analyst in the Rates Department of the Financial Analysis Division; Mike Ostrander, an Accountant in the Accounting Department of the Financial Analysis Division; and Burma Jones, an Accountant in the Accounting Department of the Financial Analysis Division. The following Staff witnesses have also submitted testimony in this case: Janis Freetly, Senior Financial Analyst in the Finance Department of the Financial Analysis Division; Christopher Boggs, a Rate Analyst in the Rates Department of the Financial Analysis Division; and Thomas Q. Smith, Economic Analyst in the Water Department of the Financial Analysis Division.

The following Intervenor witnesses submitted testimony in this case: John Bayler, General Manager of Lake Wildwood Association; Randy Hart, a Resident in the Lake Wildwood community; Paula Lang, General Manager of Apple Canyon Lake Property Owners' Association, Inc.; and Scott J. Rubin, an Independent Consultant and Attorney.

B. THE COMPANIES' SERVICE AREAS AND NATURE OF OPERATIONS

Apple Canyon Utility Company and Lake Wildwood Utilities, Corp. are wholly owned subsidiaries of Utilities, Inc. ("UI"). Water Service Corporation ("WSC") manages

the operation for all of UI's water and wastewater systems, including Apple Canyon and Lake Wildwood. WSC provides management, administration, engineering, accounting, billing, data processing, and regulatory services for the utility systems. WSC's expenses are assigned directly to a utility or distributed to the various companies pursuant to a formula that has been approved by the Commission.

Apple Canyon provides water usage service to approximately 890 customers and water availability service to approximately 1,800 customers in JoDaviess County. Lake Wildwood provides water usage service to approximately 460 customers and water availability service to approximately 950 customers in Marshall County.

Apple Canyon's last rate increase occurred in 2004, Docket No. 03-0399. In the final Order in that docket, for the test year ending December 31, 2002, the Commission approved rate base in the amount of \$561,696, a rate of return of 8.49%, which represents a return on common equity of 9.97%, with base rate revenues of \$272,306. (*Apple Canyon Utility Company, Proposed General Increase in Water Rates*, No. 03-0399, (the "Apple Canyon Rate Order") Order of April 7, 2004, at 23-25).

In this docket, Apple Canyon seeks an increase in its base rate revenue requirement by the amount of \$367,663 to recover the test year deficiency. The current monthly average consumption for 5/8" residential customers in Apple Canyon is approximately 1,767 gallons. This equates to a monthly bill of \$13.75. Based on an average consumption of 1,767 gallons per month, the customers' monthly bill will be \$45.93 or an increase of \$32.19 per month.

Lake Wildwood's current rate structure was approved pursuant to an order contained in Docket No. 01-0663 dated August 7, 2002. In the final Order in that docket, for the test year ending December 31, 2000, the Commission approved rate base in the amount of \$550,783, a rate of return of 9.82%, which represents a return on common equity of 10.90%, with base rate revenues of \$215,124. (*Lake Wildwood Utilities Corporation, Proposed General Increase in Water Rates*, No. 01-0663, (the "Lake Wildwood Rate Order") Order of August 7, 2002, at 3-6).

In this docket, Lake Wildwood seeks an increase in its base rate revenue requirement by the amount of \$273,589 to recover the test year deficiency. The current monthly average consumption for 5/8" residential customers in Lake Wildwood is approximately 2,200 gallons. This equates to a monthly bill of \$11.57. Based on an average consumption of 2,200 gallons per month, the customers' monthly bill will be \$65.47 or an increase of \$53.90 per month.

C. TEST YEAR

Both Apple Canyon and Lake Wildwood's filings are based on a historical test year ending December 31, 2008, with *pro forma* adjustments for known and measurable changes. Staff did not challenge the reasonableness of using the year 2008 as a historical test year.

The Commission concludes that the test year ending December 31, 2008, with adjustments for known and measurable changes, is appropriate for the purposes of this proceeding.

II. RATE BASE

In their testimony, the Companies presented evidence showing their original cost rate base after pro forma adjustments for the test year ending December 31, 2008. Staff proposed various adjustments to the Companies' rate base including adjustments to utility plant, accumulated depreciation, deferred charges, and working capital. Staff's proposed adjustments are summarized in the sections below and are included in Appendices A and B. The Companies accepted all of Staff's recommended rate base adjustments. The Intervenor, however, seek assorted adjustments, including for the Billing and Accounting Systems and for Plant Additions.

A. RESOLVED ISSUES

1. Adjustment to Utility Plant – Abandoned Well

Staff determined that the utilities have abandoned two wells that are no longer used and useful for the provision of utility service. (Staff Ex. 6.0, p. 9). Staff witness Ostrander proposed adjustments to reduce the test year utility plant amount for utility plant that has been retired, and is no longer used and useful, but is included in gross utility plant in the Companies' filings. (Staff Ex. 7.0, Schedules 7.7 AC and LW). Corresponding adjustments to accumulated depreciation and depreciation expense were made. The Companies did not contest these adjustments. (ACUC-LWUC Ex. 6.0, p. 2).

2. Adjustment to Accumulated Depreciation

Staff witness Ostrander proposed adjustments to properly reflect the increase in accumulated depreciation during the post-test year time period. (Staff Ex. 7.0, Schedules 7.9 AC and LW). These adjustments were proposed because the Companies have not properly reflected both known and measurable increases and decreases that impact "net" utility plant investment from known and measurable changes that occurred from January 2009 through June 2009. The Companies, through their pro forma plant additions adjustments, have reflected increases to gross utility plant during the post-test year period through June 30, 2009. However, plant should also be offset by the known changes to accumulated depreciation through June 30, 2009. The Companies did not contest these adjustments. (ACUC-LWUC Ex. 6.0, p. 2).

3. Adjustment to Deferred Charges

Staff witness Ostrander proposed adjustments to remove deferred charges from rate base because the Commission has not authorized the deferral. (Staff Ex. 7.0,

Schedules 7.10 AC and LW). The instructions to Account 186, Miscellaneous Deferred Debits, require the Commission's authority for the deferral of costs. The Companies did not contest these adjustments. (ACUC-LWUC Ex. 6.0, p. 2).

4. Adjustment to Working Capital

Staff witness Ostrander proposed adjustments to working capital for the removal of real estate taxes and to incorporate the effects of other Staff-proposed adjustments. (Staff Ex. 7.0, Schedules 7.12 AC and LW). The Companies did not contest the removal of real estate taxes from the working capital calculation. (ACUC-LWUC Ex. 6.0, p. 3).

B. CONTESTED ISSUES

1. Adjustment for the Billing and Accounting Systems

a) Intervenors' Position

The Intervenors argue that both utilities are attempting to improperly include in rates allocated costs associated with a new customer billing program and a new accounting program. They state that the development of a nationwide billing software system cost \$7,124,532 of which ACUC seeks to include \$64,228 in rates and LWUC seeks to include \$34,081. The new nationwide accounting software system cost \$14,328,103 of which Utilities, Inc. assigned \$129,168 to ACUC and \$68,540 to LWUC. According to the Intervenors, Utilities, Inc. did not conduct any studies or analysis as to whether either of the systems is appropriate or useful for the Companies and therefore it is inappropriate to include the costs for these systems in either ACUC's or LWUC's rates.

The Intervenors maintain that both utilities are very small systems with LWUC having about 460 active customers who receive monthly bills for water consumption and 950 availability customers who receive a flat bill for the standby service. ACUC has about 890 active customers who receive bills quarterly and about 1,800 availability customers who receive a flat bill for the standby service. Based on these numbers, the Intervenors argue that the sophisticated billing and accounting systems were not designed for the Companies and are not necessary.

They argue that ACUC and LWUC's claimed benefits for the billing system are illusory to the ratepayers because they rarely pay their bills by walking into the bill payment centers located miles away from the service area and mail-in payments are handled no differently with the new system than they were before it was installed. They argue further that there is no reason why ratepayers in Illinois should pay for a purported "benefit" for customers in 15 other states—a benefit primarily for Utilities, Inc., not ACUC nor LWUC ratepayers.

Still further, the Intervenor argue that the new billing system has not properly worked in Illinois either because of the system itself or employees not being properly trained on how to use the systems. There is no indication that the new systems have improved the efficiency or accuracy of billing and customer service information to Illinois consumers according to the Intervenor. They maintain that the costs of the system should be excluded from rates as was done in Kentucky, when Utilities, Inc. attempted to include the same billing system costs in rates for the operating utility in that state.

In *Application of Water Service Corporation of Kentucky for an Adjustment of Rates*, Case No. 2008-00563, the Commission rejected the inclusion of any of the \$178,715 in costs associated with the billing system because the utility failed to conduct any studies or analysis as to the benefits to the ratepayers of a system the size of the Kentucky system (7,305 customers). *Application of Water Service Corporation of Kentucky for an Adjustment of Rates*, Case No. 2008-00563 at 6, entered Nov. 9, 2009. In these dockets, both ACUC and LWUC did not present any studies or analysis as to the benefits to the ratepayers for systems that are one-tenth or less than the system in Kentucky, so the logic of the Kentucky case is applicable here as well.

The Intervenor's final argument is that not only are the billing program and accounting system not useful to ACUC and LWUC, but they are inordinately expensive for systems the size of ACUC and LWUC and the cost allocated on a per customer basis is far in excess of what other Utilities, Inc. customers have been allocated. They maintain that the monthly allocated costs per ACUC customer is \$4.76 and \$4.86 per LWUC customer. The Intervenor note that according to Mr. Lubertozi, the average Utilities, Inc. customer nationwide has been allocated costs for the billing and accounting systems that average \$1.50 per month per customer and thus by the utilities own admission, the amount allocated to ACUC and LWUC is imprudent and unreasonable since the ratepayers here are paying nearly \$3.50 per month more, or triple, what other Utilities, Inc. customers pay nationwide. Even if the Commission were to find that some costs for the billing and accounting systems should be included in rates, the amount included should not exceed the nationwide average of \$1.50 per customer per month.

The Intervenor argue that with the elimination of the costs associated with the billing system ACUC's rate base is reduced by \$64,228 and ACUC's depreciation expense by \$9,178. LWUC's rate base would decrease by \$34,081, and LWUC's depreciation expense would decrease by \$4,870. Rejection of the costs associated with the JD Edwards accounting system from ACUC's and LWUC's rates reduces ACUC's rate base by \$129,168, ACUC's depreciation expense by \$18,458, LWUC's rate base by \$68,540, and LWUC's depreciation expense by \$9,782.

b) Staff's Position

Staff argues that the Intervenor's proposal to disallow the cost for the billing and accounting systems because the amount included in rates for the customers of LWA and ACLPU should not exceed the nationwide average of \$1.50 per customer per

month asserted by Company witness Lubertozzi should be disregarded. Staff maintains that although the calculation of the revenue impact on a customer's bill cites to information located in the record from the testimony of the Companies and Staff, it does not consider all the necessarily related items in the revenue requirement. Staff argues that the statement that the nationwide average cost per customer is \$1.50 has not been substantiated with workpapers, the record does not include the basis of the calculation, it is too late in the proceeding to conduct discovery so as to get the basis of the calculation into the record, and a comparative analysis cannot be conducted without knowing the basis of the calculation. Staff maintains that had the Intervenor's presented the allocated costs calculation in testimony, the parties would have had the opportunity to conduct analysis and possibly produce a more representative allocated cost of the billing and accounting systems on the bills paid customers of ACUC and LWUC.

That being said, Staff believes that the Intervenor's calculation lacks several elements that are essential in the calculation of any revenue requirement, e.g. accumulated depreciation, accumulated deferred income taxes, and interest synchronization adjustment. The Intervenor's calculation also includes an error; the weighted cost of debt should be 3.47%, not 3.37%. The Intervenor's calculation fails as well to take into consideration direct costs associated with operating computer systems such as maintenance agreements and personnel costs. As such, the Intervenor's calculation does not produce a representative allocated cost of the billing and accounting systems on a per customer basis. Thus, Staff cautions the Commission in accepting the Intervenor's proposal based upon calculations provided in the Intervenor's Initial Brief.

c) Companies' Position

The Companies argue that the Intervenor's argument for denying recovery of the expenditures for the replacement of the Companies' existing customer care and accounting systems must be rejected because they provided no evidence of an actual lower cost reasonable alternative. They explain that the systems needed to be replaced and that they were assisted by a renowned consulting firm in developing the business case supporting the selection of the replacement systems.

The Companies also argue that Intervenor's contention that a stand-alone system would be different is irrelevant as Apple Canyon and Lake Wildwood are not stand-alone companies as they are part of a larger organization that enables them to benefit by spreading fixed costs over a larger customer base. The idea that imaginary stand-alone systems might be cheaper would be at odds with a reason for the Commission's approval of reorganizations and affiliated interest agreements, that is, the transparent cost savings to be gained by affording smaller companies the advantage of economies of scale.

They counter that no Intervenor witness came up with an example of a less costly, reasonable alternative for the obsolete accounting and customer care software

systems that needed replacing. Further, the Companies state that Intervenor's reliance on a Kentucky order is misplaced as the order shows no indication that the regulatory processes are comparable. The Kentucky order merely indicates that in that case, the company had not met its burden to document the reasonableness of the project. In Illinois, the documentation is readily available to Staff and Intervenor's, who are permitted to inquire into every facet of the utility's operations, and have the opportunity to request and review every record kept by the utility. The Illinois process provides the Staff and intervenors with access to the information they need to support disallowance of a cost actually incurred by the utility based on any suspected inefficiency or bad faith.

The Companies counter the Intervenor's argument that Illinois should follow Kentucky's lead because the Companies did not conduct any studies or analysis to justify the acquisition of the replacement systems. They state that while the Kentucky regulators may not have been made aware of such information, the Companies' testimony in this case demonstrated that a renowned consulting firm had been retained, who prepared a business case supporting the selection. The Intervenor's could have requested the business case records to look for flaws, and then presented testimony supporting their opinions.

The Companies argue that Intervenor's argument that some features of the customer care system do not benefit the Companies' customers is a red herring because the obsolete existing system needed to be replaced. The Companies continue that the fact that the replacement system included, at no extra cost, features that may not benefit every customer is immaterial because that fact does not obviate the need for the replacement system.

Finally, the Companies assert that the calculations in the Intervenor's Brief were not performed by a witness in the case, who would have had to justify the methods and values used under cross examination. By waiting to provide these unsworn statements until the briefing stage, the Companies were deprived of the opportunity to examine the justification for the methods and values chosen, and present evidence showing the flaws. The Companies are required to allocate shared costs based upon the factors specified in the affiliate interest agreement approved in Docket 08-0335, which includes availability customers. The accounting and billing systems support the investment in and maintenance of the Companies' fixed assets. According to the Companies, no valid reason has been given why availability customers would not share the fixed costs of these systems, just as they share the fixed costs of mains and other facilities.

d) Commission Analysis and Conclusions

After our review of the record, we agree with Staff and the Companies' position. We find it is proper to include in rates allocated costs associated with the new customer billing and accounting programs. The Companies explained that the systems needed to be replaced and that they were assisted by a renowned consulting firm in developing the business case supporting the selection of the replacement systems. We also find

that Apple Canyon and Lake Wildwood are not stand-alone companies, but are in fact part of a larger organization in which costs are spread over a larger customer base. Further, the Intervenor failed to present allocated costs calculation in testimony. Had the Intervenor done this, as Staff mentions above, the parties would have had the opportunity to conduct analysis and possibly produce a more representative allocated cost of the billing and accounting systems on the bills paid by the Companies' customers.

2. Adjustment to Utility Plant – Pro Forma Plant Additions

a) Staff and the Companies' Position

Staff witness Ostrander proposed adjustments to utility plant to disallow those 2009 pro forma plant additions that he determined were not known and measurable in accordance with 83 Ill. Adm. Code 287.40. (Staff Ex. 7.0, Schedules 7.8 AC and LW). These adjustments were proposed because the Companies included in the pro forma plant additions the actual costs of plant additions through June 30, 2009 plus an estimate of costs through December 31, 2009 which represents double the amount of actual costs through the first half of 2009. Staff maintained that since the estimated costs for the July – December 2009 period are merely a repetition of the additions for the prior six months, they are not known and measurable and are therefore being disallowed. Corresponding adjustments to accumulated depreciation, accumulated deferred income taxes and depreciation expense were made. The Companies did not contest these adjustments. (ACUC-LWUC Ex. 6.0, p. 2).

b) Intervenor's Position

The Intervenor argues that capital additions have had almost no impact on overall utility expenses. In support thereof, they maintain that: (1) the capital additions were offset by the depreciation expenses that were in rates during the period when the new plant additions were installed; (2) neither utility had any major capital projects in the test year nor does either utility plan any capital projects in the foreseeable future; and (3) there is no need for several layers of management to oversee major capital construction projects for these utilities, since none occurred in the test year and none are forecast.

c) Companies' Rebuttal

The Companies' argue that the Intervenor's comparison of cumulative depreciation expense since the last rate case and the capital projects listed in the Companies' direct testimony incorrectly assume the described capital projects were all inclusive of capital investment made since the last rate cases, and ignores the general ledger additions that would have occurred. The Companies explain that rate base grows as a result of projects and general ledger additions and that their testimony in this matter merely highlighted significant projects and that general ledger additions over the seven year period were not included.

The Companies assert that Apple Canyon's 2008 net rate base is \$788,041,

which reflects the reductions for depreciation since the last rate case. (ACUC-LWUC Ex. 6.0, Sch. 6.1AC, p. 8, line 23). Net rate base has increased by over \$226,000 from the amount that Intervenor say existed seven year ago, and the increased rate base investment made by Apple Canyon is more than 10 times the amount Intervenor think occurred. The Companies also argue that Lake Wildwood's 2008 net rate base is \$781,090, an increase over 9 years of more than \$230,000, (ACUC-LWUC Ex. 6.0, Sch. 6.1LW, p. 8, line 23), which confirms that since that last rate case Lake Wildwood has invested much more in rate base than Intervenor's Brief claims occurred. The Companies surmise that the Intervenor's error is a result of failing to account for general ledger additions.

d) Commission Analysis and Conclusions

Staff disallowed duplicative costs as not being known and measurable and made corresponding adjustments to accumulated depreciation, accumulated deferred income taxes and depreciation expense. The Companies accepted these adjustments. The Intervenor argue that further adjustments are warranted as capital additions have had almost no impact on overall utility expenses. In our view, Intervenor adjustments are not supported by the evidence. We find that Staff's adjustments which were accepted by the Companies are reasonable.

C. COMMISSION CONCLUSION ON RATE BASE

The Commission finds that the adjustments to rate base proposed in Staff's exhibits are supported by the evidence, are reasonable, and should be adopted. Upon giving effect to these adjustments, the Commission concludes that the rate base for Apple Canyon approved for purposes of this proceeding is \$783,003 while the rate base for Lake Wildwood approved for purpose of this proceeding is \$778,092. These rate bases may be summarized as follows:

Apple Canyon Utility Company

Gross Plant in Service	\$ 2,833,414
Less: Accumulated Depreciation	<u>(987,544)</u>
Net Plant	1,845,870

Additions to Rate Base	
Working Capital	31,007
Adjustment to Rate Base Allocations	(228)
Deferred Charges	0
Net Pro Forma Plant	50,504
Adjustments from Prior Rate Cases	-

Deductions From Rate Base

Contributions in Aid of Construction	(965,357)
Accumulated Deferred Income Taxes	(124,602)
Customer Deposits	-
Adjustments from Prior Rate Cases	(54,191)
Rate Base	<u>\$ 783,003</u>

Lake Wildwood Utility Corporation

Gross Plant in Service	\$ 1,265,188
Less: Accumulated Depreciation	(408,771)
Net Plant	<u>856,417</u>

Additions to Rate Base	
Working Capital	19,286
Adjustment to Rate Base Allocations	59
Deferred Charges	(0)
Net Pro Forma Plant	<u>39,069</u>

Deductions From Rate Base	
Contributions in Aid of Construction	(107,181)
Accumulated Deferred Income Taxes	(29,556)
Customer Deposits	(2)
Rate Base	<u>\$ 778,092</u>

The development of the approved rate base adopted for Apple Canyon for purposes of this proceeding is shown in Appendix A to this Order while the approved rate base adopted for Lake Wildwood is shown in Appendix B to this Order.

III. OPERATING REVENUES AND EXPENSES

The Companies assert that rate increases are necessary to permit them to recover their operating expenses and to permit them to earn a fair rate of return on their capital investments. The Companies presented evidence showing their pro forma operating revenues, expenses and income for the test year which ends on December 31, 2008. Staff proposed various adjustments to the Companies' pro forma operating statements. The Intervenor proposed adjustments as well.

A. RESOLVED ISSUES

1. Pro Forma Expense

Staff witness Jones proposed an adjustment to disallow increases to expenses that are based on an inflation factor. (Staff Ex. 2.0 p.4, Schedule 2.1AC and 2.1LW and

Staff Ex. 8.0 C p. 3, Schedule 8.1AC and 8.1LW). Pro forma adjustments to an historical test year should be based upon known and measurable changes; inflation factors are not known and measurable. Staff's adjustment decreases maintenance and general expenses for each company. The Companies agreed with the adjustment. (ACUC-LWUC Ex. 4.0, p.4).

2. Add-On Taxes

Staff witness Jones proposed an adjustment to remove the Gross Revenues tax (also known as the Public Utility Fund tax) from the Company's revenue requirement and recommended that the Company collect the tax as a separate charge on customers' bills when the rates approved in this docket go into effect. (Staff Ex. 2.0 pp. 3-4, Schedule 2.2AC and 2.2LW and Staff Ex. 8.0 C pp. 3-6, Schedule 8.2AC and 8.2LW). The tax, which is an add-on charge to customers' bills, is not an actual operating expense of the utility and, therefore, should not be included in tariffed rates. The Companies agreed with the adjustment and recommendation. (ACUC-LWUC Ex. 6.0, p.3).

3. Operations and Customer Service Employee Expenses

Staff witness Jones proposed an adjustment to update operations and customer service employee expenses to reflect known and measurable changes to test year expenses for actual costs incurred in 2009 for salaries, payroll taxes, and benefits. (Staff Ex. 8.0 C pp. 14-15, Schedule 8.6AC and 8.6LW). The adjustment also reflects the change in the Regional Vice President ("RVP") allocation factor due to the RVP organizational change that occurred in 2009. The adjustment for Apple Canyon incorporates Staff's proposed adjustment in direct testimony to correct the allocation factor for employee Nathan Brant. (Staff Ex. 2.0 p. 9, Schedule 2.4AC). Staff's adjustment was not specifically addressed by the Companies in testimony, but the adjustment was included in the revenue requirements filed with the Companies' surrebuttal testimony. (ACUC-LWUC Ex. 6.0, Schedule 6.1AC, p. 3 and 6.1LW, p. 3).

B. CONTESTED ISSUES

1. Test Year O&M and General Expenses

a) Staff's Position

Staff argues that increases to expenses of the magnitude experienced in 2008 over previous years' expenses are not reasonable. Staff maintains that its witness, Burma Jones, proposed an adjustment to test year O&M and General Expenses to reflect a more reasonable level of expense to include in base rates. (Staff Ex. 2.0 p. 7, Schedule 2.4AC and 2.4LW and Staff Ex. 8.0 C p. 10, Schedule 8.4AC and 8.4LW). Ms. Jones' proposed adjustment is based on the five-year average of expenses reported on Form 22 ILCC for the years 2004 through 2008. The gross adjustment is the difference between the five-year average and the comparable test year expenses on Company Schedule B. The net adjustment reflects the removal of the overlapping

effect of other staff adjustments to comparable test year expenses. (Staff Ex. 2.0 pp. 7-8).

Staff notes that Company witness Steven Lubertozi takes issue with Staff's methodology inasmuch as he opines that historical averaging would be appropriate if costs were declining, but certain costs are increasing. Staff counters that Mr. Lubertozi has not demonstrated that the net effect of changes to all costs represents an increase and that in discussing 2009 comparable costs for the Companies, Mr. Lubertozi states that actual incurred expense for Apple Canyon is \$353,094 and for Lake Wildwood is \$212,174. These amounts are less than the amount reported in the respective Company's 2008 Annual Report (\$399,063 for Apple Canyon and \$218,870 for Lake Wildwood). (Staff Ex. 8.0C pp. 12-13).

Staff argues that even if Mr. Lubertozi accurately attributes the majority of the increase in expenses to salaries and related benefits, the information provided by the Company indicates that Utilities, Inc. has begun to downsize its staff and consolidate positions due to the lack of necessity in direct relation to the amount of capital improvements that are planned for future years. (*Id.*, pp. 11-12) The number of employees decreased from approximately 501 at the end of the test year to 436 at the end of 2009. Staff asserts that it is logical to assume that salaries and related benefits will decrease as a result of the downsizing and consolidation. (*Id.*, p. 13)

Staff argues that not only have the Companies have failed to explain why the large increase in its O&M and general expenses for the test year is reasonable, it has provided evidence that the test year level will not be sustained. Staff concludes that its adjustment, which is based on known historical spending levels, is a more just and reasonable level of expense on which to calculate rates and is offered as a reasonable way to mitigate the large increase in test year expenses over previous years' expenses.

b) Companies' Position

The Companies argue that Staff's adjustments to actual test year expenses are not justified because they do not more accurately portray the reasonably expected level of costs over the period of time the rates set in this proceeding will be in effect. Staff proposed to reduce O&M expenses from the actual 2008 test year amounts to the lower average of these expenses for the five year period from 2004 to 2008. The Companies disagree with Staff's approach to selectively review and reduce the expense for one account simply because the test year expense for that account may be higher than spending in previous years. The Companies argue that this approach fails to recognize that costs associated with a utility's recurring business activities can impact any particular account differently from year to year. The Companies maintain that while Staff speculates expenses in one specific account may decrease from the test year level, the test year levels in certain other accounts are going to understate prospective costs if for no other reasons than regularly recurring inflation, an increasingly aging system or more stringent future environmental compliance costs. The Companies conclude that a utility will never have the opportunity to recover its actual expenses

when only certain accounts that are above remote historical averages are reduced while post test year increases in expenses in other accounts will not be recovered.

The Companies argue that rates are set prospectively, not retrospectively, so historical expenses for this account from six years ago are much less relevant than what the expenses have been more recently and what they will be going forward. They maintain that the first full year the rates approved in this proceeding will be in effect will be 2011, and Staff expects the rates to remain in effect until 2015. (Ill. C. C. Staff Ex. 2.0, p. 7, lines 128 - 130.). Using a 5 year average that includes expense levels 7 years removed (2004 v. 2011) from the initial year when the rates will be in effect creates an artificial number that the record in this case establishes is not only well under the costs experienced in the 2008 test year, but well under the level experienced in 2009. The Companies argue that Staff did not determine these test year expenses to be unnecessary.

The Companies argue that the purpose of allowing known and measurable changes is to permit the test year to reflect, as nearly as possible, the reality that will exist when the new rates go into effect. They maintain that adjustment for known and measurable changes must be certain of effectuation, and should be allowed only where the amounts of "the changes are determinable" and counter that Staff's O&M expense adjustment based on an average from the distant past that includes 2004 obviously does not reasonably reflect the costs the Companies will face after the conclusion of this case. According to the Companies, the changes from the 2008 test year O&M that Staff assumes will occur are known not to have occurred, since 2009 actual expenses exceeded the Staff's average. In 2009, these expenses were in line with the expenses incurred during the 2008 test year. (ACUC-LWUC Ex. 4.0, p. 10.). The Companies conclude that Staff's recommendation would subvert the purpose of permitting only known changes.

The Companies further contend that Staff's projection of the future O&M costs derived from the past is no more reliable than the projected inflation which the Staff rejected as a basis for adjustment to the test year level of expenses. The known 2009 data shows Staff's assumption (Ill.C.C. Staff Ex. 8.0C, p. 13) that these expenses will drop back to levels more like the past is speculative. The Companies argue, however, that as future inflation estimates do not meet the criteria for "known and measurable changes," neither should an assumption that expenses will return to pre-test year historical levels, especially where the historical years have not been adjusted to reflect the price increases for the expenditures made in 2004 through 2007. Staff's averaging approach excludes the full impact of known inflation that has occurred since 2004 according to the Companies. The Companies citing increases in billing postage, liability insurance, electricity, gas, telephone, gasoline prices, health care costs (among the accounts Staff acknowledges are included in O&M) and cost of living employee pay raises occurring since the 2004 expenditures assure that the costs faced by the Companies to procure the same items in 2011 will be more than Staff would reflect in rates set to recover those costs in 2011. Staff did not index or revise the 2004

expenses or any other pre-test year costs to recognize the 6% annual increases for water and sewer maintenance costs that the Consumer Price Index indicates have occurred from January 2004 to March 2010. (ACUC-LWUC Ex. 6.0, p. 4.) From 2007 to 2009, the year-over-year health care costs allocated to the Companies have increased 16.84% and 14.46%, and are estimated to experience even greater increases in 2010. (ACUC-LWUC Ex. 4.0, p. 10.)

The Companies argue that even if it were known that services and purchases would revert to the levels of the distant past, the cost of that level of service should be reflected at the current price, rather than be based on prices paid over seven years prior to the period when the rates will be in effect.

The Companies also find that Staff's speculation that the Companies' O&M expenses will decrease by 47% and 36% (ACUC-LWUC Ex. 4.0, p.10) is irreconcilable with the change in the test year level known to have occurred in 2009. If the 2008 test year expenses were adjusted in accordance with the Commission rules for known and measurable changes, then the actual 2009 results should be used. Staff used 2009 results as the basis for other adjustments, so it would be inequitable to exclude from consideration the actual 2009 O&M data in determining the cost to be recovered in the rates that will go into effect in late 2010. The Companies believe that if the Commission decides to adopt an averaging methodology, the three most recent and relevant years, 2007 through 2009 should be used. Separate schedules reflecting inclusion of the 2009 expenses in Staff's 5 year average and using the average for 2007 through 2009 were attached to the Companies' surrebuttal testimony. (ACUC-LWUC Ex. 6.0, p. 5 - 6.).

c) Intervenor's Position

The Intervenor argues that because the utilities offer only speculation, rather than verifiable facts, to suggest that their 2008 O&M expenses will increase, ACUC and LWUC have failed to carry their burden of proof to justify the higher O&M costs that they seek to include in rates. They argue that because Utilities, Inc. plans to continue decreasing its staff, it is inappropriate to use inflated O&M expenses for purposes of setting rates. The Intervenor contends that allowable O&M expenses should be adjusted downward past Staff's recommendation. The Intervenor suggests that rather than reviewing each O&M salary expense individually, the costs associated with Utilities, Inc. Northbrook Center should be eliminated.

d) Staff's Rebuttal

In its Reply Brief, Staff states that contrary to what the Companies have stated in their Initial Brief, it did not selectively review and reduce the expense for one account simply because the test year expense for that account may be higher than spending in previous years. Staff maintains that its adjustment encompasses all expenses except depreciation, taxes, and amortization of CIAC and its adjustment considers expenses in total over a period of years, which belies the Companies' opinion that "Staff's approach

fails to recognize that costs associated with a utility's recurring business activities can impact any particular account differently from year to year."

Staff also disagrees with the Companies' position that historical expenses are much less relevant than current and future expenses. When expenses fluctuate dramatically from year to year, historical amounts provide a basis for determining a normal level of expenses on which to base rates. Staff states that test year expenses for Apple Canyon are 139.5% greater than 2007 expenses and more than double the expenses incurred in previous years and that although test year expense increases for Lake Wildwood are not of the magnitude experienced by Apple Canyon, the increase ranges from 42% over 2007 expenses to 137% over 2004 expenses. (Staff Ex. 2.0, p. 8) Staff argues that by including 2008 with its large increase in the 5-year average, its approach does take into account the fact that costs do tend to increase over time.

Staff maintains that the Companies' argument that Staff's adjustment is not "known and measurable" is misplaced because it is the general practice of the Commission to allow some adjustments other than those that are "known and measurable" in a historical test year. Staff argues that the Commission routinely allows regulatory adjustments and normalization adjustments and that regulatory adjustments reflect Illinois regulatory policy as demonstrated in the Illinois Public Utilities Act (the "Act"), the Commission's rules found in 83 Illinois Administrative Code, prior Commission orders, and Commission practice. Examples of regulatory adjustments include the removal of promotional advertising and political and lobbying expenses. Rate case expense, which is never completely "known and measurable" until the rate case is completed, also falls into this category as being a regulatory adjustment. Staff explains that normalization adjustments smooth the impact of unusual levels of revenues or expense and that they essentially re-state specific test year data to reflect normal conditions. Examples include adjustments for weather normalization, storm damage, tree trimming, and uncollectible expense. According to Staff, its adjustment falls into this normalization category and restates 2008 expenses to a normalized level of expenses and presents a more just and reasonable level of expense that will be in effect during the period that rates are in effect.

The Company argues for the use of 2009 data for O&M expenses which Staff says that it did evaluate. Staff found that Utilities, Inc. began to downsize its staff and consolidate positions in 2009 due to the lack of necessity in direct relation to the amount of capital improvements that are planned for future years. The number of employees decreased from approximately 501 at the end of the test year to 436 at the end of 2009. Staff states that for these reasons, it believes the normalization adjustment proposed by Ms. Jones, which considers the results from multiple years including the increases in the 2008 test year, presents a more just and reasonable level of expense on which to calculate rates.

e) Companies' Rebuttal

The Companies reiterate in their Reply Brief that Staff relies on the actual O&M

expense incurred in 2009 to support its use of a 5 year average instead of the 2008 test year level. The Companies maintain that if Staff is willing to rely on the 2009 known and measurable change from the test year level to support its position, there is no justifiable reason for excluding 2009 from the calculation of an average level. The Companies argue that if the Commission is going to use an average in lieu of the test year, it should use a three year average for 2007, 2008 and 2009, or at least Staff's 5 year average should include 2009 and exclude 2004. The Companies conclude that either alternative is more likely to result in rates that reflect the costs the Companies will incur in the future when the rates are in effect.

f) Commission Analysis and Conclusions

In our view, and after our analysis, we agree with Staff's position that the increase in expenses from 2007 to 2008 is not reasonable and should be adjusted. Its proposed adjustment to test year O&M and General Expenses based on the five-year average of expenses for the years 2004 through 2008 and encompassing all expenses except depreciation, taxes, and amortization of CIAC is reasonable. We agree with Staff that its adjustment restates 2008 expenses to a normalized level and presents a more just and reasonable level of expense during the period that rates are in effect given the fact that Utilities, Inc. began to downsize its staff and consolidate positions in 2009 due to the lack of necessity in direct relation to the amount of capital improvements that are planned for future years.

2. Adjustment for Unaccounted-for Water

a) Staff and the Companies' Position

Apple Canyon has located and repaired several leaks in its water system that had resulted in higher than expected unaccounted-for-water levels. (AC Ex. 2.0, p. 19). Staff witness Smith found that the leaks have resulted in high unaccounted-for water quantities and stated that Apple Canyon should continue its program of identification and repair of leaks in its water system. (Staff Ex. 6.0, p. 10). Staff witness Ostrander proposed adjustments to decrease maintenance expenses because the unaccounted-for water percentage exceeded the maximum as defined by the Companies' tariffs. (Staff Ex. 7.0, Schedules 7.11 AC and LW). The adjustments limit the costs ratepayers bear for unaccounted-for water to what the Commission has set forth as reasonable in each Company's tariffs. The Companies did not contest these adjustments. (ACUC-LWUC Ex. 6.0, p. 2).

b) Intervenor's Position

The Intervenor's argue that Staff makes minor adjustments to maintenance expenses for the high level of unaccounted for water (UFW) by both utilities. For ACUC, the unaccounted for water rate was 62.7 percent in the second quarter of 2009. However, it continually experienced UFW rates in the range of 50 percent or worse since early 2008. The Intervenor's state that the fact that this level of UFW has been

allowed to persist for two years raises questions as to the quality of the utility's management. For LWUC, the UFW rate is 23.63 percent, which is above its allowable rate. The Intervenor conclude that Staff's adjustment only reduces ACUC's maintenance expense by \$7,359 and LWUC's by \$1,344 and that such a small adjustment is meaningless and will not encourage the utilities to undertake proper maintenance to reduce the UFW.

c) Staff's Rebuttal

Staff states in its reply brief that while the Company noted and Staff agreed that Apple Canyon's unaccounted for water is greater than expected, and that it is appropriate for Apple Canyon to work toward reducing the amount of unaccounted for water; there is no evidence, or claim by Staff that lack of proper, prudent, and efficient management was a cause, or even a contributing factor, to the problem. Staff adds that it's adjustments to operating expenses for unaccounted for water for the two companies were based on the requirements of the Companies' tariffs. It argues that there is no basis to claim that these adjustments were made based on the Companies' lack of proper, prudent, and efficient management anymore than there is any support for the Intervenor's suggestion that Staff's adjustments for Unaccounted for Water are not large enough. There is nothing in the record to support a larger adjustment.

Staff also notes that the Intervenor recommend that the Commission take action against the Companies because of their high levels of unaccounted for water. Staff points out that the Commission previously took action when it approved tariffs that limit the amount of cost of unaccounted for water that can be included in rates charged to customers. The record in this docket contains no support for additional action that might be taken by the Commission on this point.

Staff concludes that it proposed adjustments to decrease maintenance expenses because the unaccounted-for water percentage exceeded the maximum as defined by the Companies' tariffs. The adjustments limit the costs ratepayers bear for unaccounted-for water to what the Commission has set forth as reasonable in each Company's tariffs. These adjustments appropriately address the excess unaccounted for water and the Companies did not contest them.

d) Companies' Rebuttal

The Companies argue that the testimony in this case shows that they are actively engaged in the detection of the causes for water losses and included a thorough examination of the distribution system to pinpoint areas in need of repair. ACUC Ex. 2, pp. 10. In addition to leak detection surveys conducted by an outside consultant, the Companies conduct physical surveys on a daily basis, and have plans to employ specialized equipment to expand their efforts to identify and repair leaks.

The Companies further explained the difficulties involved with detecting leaks in a service area with over 50 miles of main and rocky terrain. Because many of the homes are only occupied for a few months per year, leaks on the customer's property obviously

may go undetected for long periods of time. The Companies point out that the Commission has recognized that the appropriate level of water loss is entirely dependant on the system involved and its peculiar characteristics and that those factors can lead to “unavoidable leakage,” or leakage in mains and services which would cost more to locate and stop than the lost water is worth. The Companies argue that the Intervenors provided no testimony that the Companies’ efforts were in any way inadequate or that there were any other cost-effective activities capable of producing lower results.

e) Commission Analysis and Conclusions

The Commission agrees with the adjustments suggested by Staff and accepted by the Companies. The adjustments limit the costs ratepayers bear for unaccounted-for water to what the Commission has set forth as reasonable in each Company’s tariffs. These adjustments appropriately address the excess unaccounted for water and the record in this docket contains no support for additional action that might be taken.

3. Corporate Employee Expenses

a) Staff and the Companies’ Position

Staff witness Jones proposed an adjustment to correct corporate employee expenses in the Company’s revenue requirement. (Staff Ex. 8.0 C p. 14, Schedule 8.5AC and 8.5LW) The amounts as filed were calculated with an incorrect Water Service Corporation (“WSC”) allocation factor. Staff’s adjustment, which is based on applying the correct WSC allocation factor to total corporate salaries, payroll taxes, and benefits, increases test year expenses. Staff’s adjustment was not specifically addressed by the Companies in testimony, but the adjustment was included in the revenue requirements filed with the Companies’ surrebuttal testimony. (ACUC-LWUC Ex. 6.0, Schedule 6.1AC, p. 3 and 6.1LW, p. 3).

b) Intervenors’ Position

Intervenors point out that Staff recommended increasing management expenses by increasing the Northbrook Center expenses whereas they had recommended eliminating all costs associated with the Northbrook Center, thereby reducing ACUC’s expenses by \$49,799 and LWUC’s by \$26,559. They argue that the announced decrease in staffing levels by Utilities, Inc. indicates that management fees at Northbrook should be decreasing, not increasing and when combined with the management failure to control UFW and to comply with proper inspection of critical valves, an appropriate adjustment would be to eliminate all management costs associated with the Northbrook Center.

c) Staff’s Rebuttal

Staff disagrees with the assessment by the Intervenors that Staff’s adjustment to corporate employee expenses is wrong for two reasons. First, the adjustment was

necessary because the corporate employee expenses reflected in the filings for ACUC and LWUC were calculated with incorrect allocation factors. Staff's adjustment applies the correct allocation factors to the total amount to be distributed to all of UI's companies to calculate Apple Canyon's and Lake Wildwood's respective portions. (Staff Ex. 8.0C, p. 14) Second, the salaries of the employees that LWA and ACLPOA appear to take exception to – Steven Winter, Jon Schoenard, Paul Burrus, Thomas Tapella, and L. Goldsmith (LWA/ACLPOA IB, pp. 24-25) – are not included in corporate employee expenses. They are included in operations employee expenses. According to Staff, disallowance of it's adjustment to corporate employee expenses would not affect the amount of expenses allocated to the Companies for these particular employees.

d) Companies' Rebuttal

The Companies argue that the Intervenor's testimony did not address the cost of management at the Northbrook corporate headquarters and what positions should be disallowed. Management at Northbrook includes the CEO, CFO, Accounting Staff, and General Counsel, among others. The Companies assert that these costs have been allocated in accordance with the affiliate interest agreement approved by the Commission in Docket 08-0335. (*Apple Canyon Utility Company, et al.*, Ill.C.C. Doc. 08-0335 (April 22, 2008.)). No valid reason has been shown why the Companies should not be permitted to recover the shared the costs of these executive functions.

e) Commission Analysis and Conclusions

Staff maintains that it's adjustment to corporate employee expenses is valid and should be adopted by the Commission. We agree. Staff's adjustment is based on applying the correct WSC allocation factor to total corporate salaries, payroll taxes, and benefits, increases test year expenses and applies the correct allocation factors to the total amount to be distributed to all of UI's companies to calculate Apple Canyon's and Lake Wildwood's respective portions. The salaries of the employees that LWA and ACLPOA take exception to are not included in corporate employee expenses, but in operations employee expenses. The Companies accepted the adjustment and the Intervenor failed to offer evidence in the record to justify eliminating all management costs associated with the Northbrook Center.

4. Rate Case Expenses

a) Staff and the Companies' Position

Staff witness Jones proposed adjustments to rate case expenses (1) to recognize updated information presented by the Company regarding actual expense incurred, (2) to account for the overlap, for ratemaking purposes, between the normal allocation of WSC personnel costs to the Company and the costs requested as rate case expense, and (3) to change the amortization period for rate case expense to five years from the three years proposed by the Company. (Staff Ex. 2.0 pp. 4-7, Schedule 2.3AC and 2.3LW and Staff Ex. 8.0 C pp. 6-10, Schedule 8.3AC and 8.3LW) The

Companies accepted Staff's adjustments to rate case expenses, including the five-year amortization period. (ACUC-LWUC Ex. 6.0, p.3).

b) Intervenor's Position

The Intervenor's seek to exclude as rate case expense the monthly statements by SFIO Consulting, Inc., which state "for services provided" during a particular month and mileage without detailing where a trip started or ended or what it was for. They also note that the Staff witness who recommended inclusion of the SFIO costs testified that she did not know what SFIO was hired to do. They argue that knowing who the principal is in SFIO and that he "worked for a utility company" is insufficient justification for inclusion of his consulting charges in rates. They claim that this does not meet the statutory requirements under 220 ILCS 5/9-229 for assessing the justness and reasonableness of any amount expended by a public utility for rate case filings and that the amounts sought should be reduced.

The Intervenor's argue that Staff's recommendation provides the Utilities with rate case expenses that are far out of proportion to the rate increase sought in these dockets. The "reasonableness" of rate case expenses must be judged not only by what was purportedly spent but by the value to ratepayers as well. They recommend that rate case expenses be limited to \$1 per active customer per month. This would reduce Staff's recommendation by \$7,061 for ACUC and \$12,985 for LWUC. They conclude that the resulting amounts would be closer to just and reasonable amounts for rate case expenses in cases involving utilities of this size.

c) Companies' Rebuttal

The Companies argue that the Intervenor's have identified no service that was not actually provided or anticipated to be provided and that the Intervenor's specific objection to the services provided by SFIO Consulting, which were allocated to five companies, stemmed from Intervenor's lack of understanding as to the nature of services provided. The Companies claim that the Intervenor's were not precluded from making data requests that would provide this information and that by failing to inquire about the nature of these services during the discovery process, Intervenor's should not be heard to complain about their lack of knowledge. Staff, assert the Companies, was familiar with the person who provided the services, and presumably was well aware of what services and value he provided to the Companies.

d) Commission Analysis and Conclusions

We agree with Staff and the Companies position. Staff's adjustments, which the Companies accepted, were proper and reasonable based upon the evidence in the record. The Intervenor's failed to convince this Commission that further adjustments were warranted based upon their arguments and the evidence that they presented in support thereof.

C. COMMISSION CONCLUSIONS ON OPERATING EXPENSE STATEMENT

Based on the utility operating expense statement as originally proposed by and the adjustments to operating revenues and expenses as summarized above, the total utility operating expenses for Apple Canyon and Lake Wildwood approved for purposes of this proceeding are \$398,052 and \$248,348 respectively. The operating income statements may be summarized as follows:

Apple Canyon Utility Company

Water Service Revenues	\$ 447,889
Miscellaneous Revenues	11,158
Total Operating Revenues	459,047
Uncollectible Accounts	18,085
Maintenance Expenses	89,487
General Expenses	138,955
Depreciation	127,466
Amortization of CIAC	(19,375)
Taxes Other Than Income	22,254
Total Operating Expense Before Income Taxes	376,873
State Income Tax	3,981
Federal Income Tax	17,198
Deferred Taxes and ITCs Net	-
Total Operating Expenses	\$ 398,052
NET OPERATING INCOME	\$ 60,995

Lake Wildwood Utility Corporation

Water Service Revenues	\$ 303,345
Miscellaneous Revenues	5,616
Total Operating Revenues	308,961
Uncollectible Accounts	9,450
Maintenance Expenses	64,016
General Expenses	75,432

Depreciation	67,010
Amortization of CIAC	(4,313)
Taxes Other Than Income	<u>15,561</u>
 Total Operating Expense Before Income Taxes	 227,156
 State Income Tax	 3,985
Federal Income Tax	17,207
Deferred Taxes and ITCs Net	<u>-</u>
Total Operating Expenses	\$ 248,348
 NET OPERATING INCOME	 \$ 60,613

The development of the overall utility operating expenses adopted for Apple Canyon and Lake Wildwood for purposes of this proceeding is shown in Appendices A and B to this Order, respectively.

IV. RATE OF RETURN

A. CAPITAL STRUCTURE

Since both of the Companies are wholly owned subsidiaries of Utilities, Inc., Staff proposed using UI's capital structure for the year ended December 31, 2008, comprised of 6.24% short-term debt, 49.81% long-term debt, and 43.96% common equity. (Staff Ex. 3.0, p. 3 and Schedule 1).

Ms. Freetly calculated the balance of short-term debt in three steps. First, Ms. Freetly calculated the monthly ending net balance of short-term debt outstanding from June 2008 through June 2009. The net balance of short-term debt equals the monthly ending gross balance of short-term debt outstanding minus the lesser of (a) the corresponding monthly ending balance of construction-work-in-progress ("CWIP") accruing an allowance for funds used during construction ("AFUDC"), or (b) the monthly ending balance of CWIP accruing AFUDC times the ratio of short-term debt to total CWIP for the corresponding month. That adjustment recognizes the Commission's formula for calculating AFUDC assumes short-term debt is the first source of funds financing CWIP¹ and addresses the double-counting concern the Commission raised in a previous Order.² Second, Ms. Freetly calculated the twelve monthly averages from the adjusted monthly ending balances of short-term debt. Third, Ms. Freetly averaged

¹ *Uniform System of Accounts for Water Utilities Operating in Illinois*, Accounting Instruction 19 Utility Plant - Components of Construction Cost (17). Long-term debt, preferred stock and common equity are assumed to finance CWIP balances in excess of the short-term debt balance according to their relative proportions to long-term capital.

² Order, Docket No. 95-0076 (Illinois-American Water Company, general rate increase), December 20, 1995, p. 51.

the twelve monthly balances of short-term debt for July 2008 through July 2009. (Staff Ex. 3.0, pp. 3-4 and Schedule 2).

Ms. Freetly adjusted the \$180,000,000 balance of long-term debt outstanding on December 31, 2008 to reflect the unamortized debt expense incurred to issue the debt, which produces a long-term debt balance of \$178,726,842. Ms. Freetly used the \$157,737,014 balance of common shareholders equity on December 31, 2008. (*Id.*, p. 5).

B. COST OF DEBT

Ms. Freetly estimated that the Companies' cost of short-term debt is 2.64%, which equals a weighted average of the current Prime rate and LIBOR rate that the Companies pay on short-term borrowings. The weighted cost of short-term debt was calculated based on the proportion of the Companies' borrowings at the Prime rate and LIBOR during the short-term measurement period.

The Companies' embedded cost of long-term debt is 6.65%, which includes the annual amortization of debt expense to reflect straight line amortization of the unamortized balance over the remaining life of the outstanding issue of long-term debt. (Staff Ex. 3.0, p. 8 and Schedule 3).

C. COST OF COMMON EQUITY

Ms. Freetly recommended a 9.82% cost of common equity for UI subsidiaries Apple Canyon and Lake Wildwood. She measured the investor-required rate of return on common equity for UI with the discounted cash flow ("DCF") and risk premium models. DCF and risk premium models cannot be directly applied to UI because its stock is not market traded. Therefore, Ms. Freetly applied those models to water utility and public utility samples (hereafter, referred to as "Water sample" and "Utility sample", respectively).

Staff's Water sample consists of domestic corporations classified as water utilities within Standard & Poor's ("S&P") *Utility Compustat II* that have publicly traded common stock and long-term growth rates from Zacks Investment Research ("Zacks"). (Staff Ex. 3.0, p. 9). Staff's Utility sample was selected using S&P credit ratings, business risk profiles and financial risk profiles for a typical water utility since UI is not rated. Ms. Freetly concluded that a credit rating of A- with a business risk profile of 'excellent' and a financial risk profile of 'significant' are representative of the business and financial risk of a typical water utility and, therefore, reasonable estimates for UI. Ms. Freetly formed her sample by selecting domestic dividend paying publicly traded corporations classified as electric or gas utilities within S&P *Utility Compustat II* that (1) have been assigned a S&P credit rating of A, A- or BBB+; (2) a business risk profile score of 'excellent'; and (3) a financial risk profile of 'intermediate', 'significant' or 'aggressive'. Companies that lacked Zacks growth rates or were in the process of being

acquired by another company or acquiring a company of similar size were not included in the Utility sample. (Staff Ex. 3.0, pp. 9-11).

1. DCF Analysis

DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments to the holders of that stock. Ms. Freetly employed a multi-stage non-constant-growth DCF model that reflects a quarterly frequency in dividend payments. (Staff Ex. 3.0, pp. 11-16).

Staff witness Freetly modeled three stages of dividend growth. The first, near-term growth stage is assumed to last five years. The second stage is a transitional growth period lasting from the end of the fifth year to the end of the tenth year. The third or “steady-state” growth rate is assumed to begin after the tenth year and continue into perpetuity. (*Id.*, p. 12).

For the first stage, Ms. Freetly used market-consensus expected growth rates published by Zacks as of February 2, 2010. To estimate the long-term growth expectations for the third, steady-state stage, she utilized the implied 20-year forward U.S. Treasury rate in ten years, 5.05%. (*Id.*, pp. 13-14). The growth rate employed in the intervening, five-year transitional stage equals the average of the Zacks growth rate and the steady-state growth rate. (*Id.*, p. 14). The growth rate estimates were combined with the closing stock prices and dividend data as of February 2, 2010. Based on these growth assumptions, stock price, and dividend data, Ms. Freetly’s DCF estimate of the cost of common equity was 9.61% for the Water sample and 10.83% for the Utility sample. (*Id.*, p. 16 and Schedule 8).

2. Risk Premium Analysis

According to financial theory, the required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security. Staff witness Freetly used a one-factor risk premium model, the Capital Asset Pricing Model (“CAPM”), to estimate the cost of common equity. (Staff Ex. 3.0, pp. 16-18).

The CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. For the beta parameter, Ms. Freetly combined adjusted betas from Value Line, Zacks, and a regression analysis to estimate the beta of the Water and Utility sample. For the Water sample, the average Value Line, Zacks, and regression beta estimates were 0.70, 0.60, and 0.55, respectively. For the Utility sample, the average Value Line, Zacks, and regression beta estimates were 0.69, 0.63, and 0.57, respectively. The Value Line regression employs weekly observations of stock return data while both the regression beta and Zacks betas employ monthly observations. Since the Zacks beta estimate and the regression beta estimate are calculated using monthly data rather than weekly data (as Value Line uses), Ms. Freetly averaged those results to avoid over-weighting betas estimated from monthly data in comparison to the weekly data-derived Value Line betas. She then

averaged the resulting monthly beta with the Value Line weekly beta, which produced a beta of 0.64 for the Water sample and 0.64 for the Utility sample. (*Id.*, pp. 24-29)

For the risk-free rate parameter, Ms. Freetly considered the 0.04% yield on four-week U.S. Treasury bills and the 4.60% yield on thirty-year U.S. Treasury bonds. Both estimates were measured as of February 2, 2010. Forecasts of long-term inflation and the real risk-free rate imply that the long-term risk-free rate is between 4.3% and 5.0%. Thus, Ms. Freetly concluded that the U.S. T-bond yield is currently the superior proxy for the long-term risk-free rate. (*Id.*, pp. 21-22).

Finally, for the expected rate of return on the market parameter, Ms. Freetly conducted a DCF analysis on the firms composing the S&P 500 Index. That analysis estimated that the expected rate of return on the market was 12.12% for the fourth quarter of 2009. (*Id.*, p. 23). Inputting those three parameters into the CAPM, Ms. Freetly calculated a cost of common equity estimate of 9.41% for both the Water sample and the Utility sample. (*Id.*, p. 29 and Schedule 9).

3. Staff Cost of Equity Recommendation

Ms. Freetly estimated the investor-required rate of return on common equity for the Water sample of 9.51% by taking the simple average of the DCF-derived results (9.61%) and the risk-premium derived results (9.41%) for the Water sample. (Staff Ex. 3.0, p. 30). Ms. Freetly estimated the investor-required rate of return on common equity for the Utility sample of 10.12% by taking the simple average of the DCF-derived results (10.83%) and the risk-premium derived results (9.41%) for the Utility sample. The investor required rate of return on common equity for Apple Canyon and Lake Wildwood, 9.82%, is based on the average for the Water and Utility samples. (Staff Ex. 3.0, p. 30).

D. COMMISSION ANALYSIS AND CONCLUSIONS

Staff witness Janis Freetly presented the overall cost of capital and recommended a fair rate of return on rate base for Apple Canyon and Lake Wildwood. (Staff Ex. 3.0 and 9.0). The Companies accepted Staff's 7.79% overall cost of capital recommendation. (ACUC-LWUC Ex. 6.0, p. 8).

The Intervenor's argue that the record in these dockets demonstrates significant management failures in following the Commission rules and regulations relating to inspection of critical valves and that when combined with the high levels of UFW, this mismanagement requires an adjustment in the return on equity to the low end of the range cited by the ICC Staff. They maintain that the return on equity should be reduced to 9.41%.

The Companies maintain that they and Staff have agreed on the rate of return recommended by the Staff witness and that because the Intervenor's failed to provide a rate of return witness there is no evidence in the record that would support selection of

a lower return based on what Intervenor perceive as operational deficiencies.

Having reviewed the record, the Commission finds that Apple Canyon and Lake Wildwood should be authorized to earn a rate of return of 7.79% on original cost rate base. The Companies did not contest Ms. Freetly's recommendations and the Intervenor failed to present evidence to support otherwise. The rate of return incorporates a return on common equity of 9.82% and was derived as shown below:

Weighted Average Cost of Capital

Source of Capital	Amount	Percentage	Cost	Weighted Cost
Short-term Debt	22,380,391	6.24%	2.64%	0.16%
Long Term Debt	178,726,842	49.81%	6.65%	3.31%
Common Equity	157,737,014	43.96%	9.82%	4.32%
Total	\$ 358,844,247	100.00%		7.79%

V. RATE DESIGN/TARIFF TERMS

A. MISCELLANEOUS FEES AND CHARGES

1. Tampering Fee

The Companies proposed to reserve the right to assess a \$50 administrative fee to a customer for tampering with Company equipment. (AC Ex. 2.0, p. 15, LW Ex. 2.0, p. 15). After reviewing the Administrative Code, Staff witnesses Boggs and Rukosuev presented arguments that this proposed fee was not in compliance with 83 Illinois Administrative Code Part 280.60(b) which states:

A utility may request a deposit pursuant to Section 280.70 herein from a present residential customer after the first 24 months that the customer has received utility service if the customer's wires, pipes, meters or other service equipment have been tampered with and the customer enjoyed the benefit of the tampering. (Staff Ex. 10.0, p. 5 and Staff Ex. 11.0, p.17)

In his rebuttal testimony, Company witness Daniel³ stated that the Companies would withdraw their requests for approval to assess the Tampering Fee of \$50.00 and would rely on 83 Illinois Administrative Code Sections 280.60 and 280.100 when applicable. (ACUC-LWUC Ex. 5.0, p. 3).

2. After Hours Call-Out Charge

The Companies proposed to establish an After Hours Call-out charge as described in Section 4C of the Company Rules, Rates and Conditions of Service. (AC Ex. 2.0, pp. 14-15, LW Ex. 2.0, pp. 14-15). The Companies proposed a minimum rate

³ Mr. Daniel adopted the direct testimony of Company witness Burris.

to be equal to two hours of current labor rate or \$106. For all time accumulated above the two hour minimum, the Company proposed to bill customers at the rate of \$53 per hour. In response to Staff DR CB 1.07, the Companies documented the average operator overtime costs, customer service costs to process the overtime request and roundtrip mileage to premises. Furthermore, in response to Staff DR CLB 1.12, the Companies stated that such a minimum charge would act as a deterrent in instances when a customer calls and requests service to an issue that can be otherwise handled during normal business hours. Although the Companies sufficiently demonstrated that the \$106 fee is reasonable for the reasons stated earlier, the proposed tariff language provides an opportunity for discriminatory treatment, since there are no clear criteria as to when such fee would be assessed. In their direct testimony, Staff witnesses Boggs and Rukosuev indicated that the proposed fee should not be approved, unless the Companies provide in rebuttal testimony, amended proposed tariff language that defines under what circumstances the fee would be applied and be compliant with 83 Illinois Administrative Code Part 280. Staff was concerned that with no standard for imposing the fee, it could be applied arbitrarily. (Staff Ex. 4.0, pp. 15-16 and Staff Ex. 5.0, pp. 12, 15-16).

Although the Companies did not provide updated tariff language, in rebuttal testimony, Company witness Daniel pointed out that, per Paragraph 4C of the Companies' existing tariffs, the Companies' Rules, Regulations and Conditions of Service currently provide the appropriate verbiage that allows the Companies to assess a charge for an After Hours Call-Out. (ACUC-LWUC Ex. 5.0, p. 3). Furthermore, Company witness Daniel pointed out that the After Hours Call-Out charge would only be applicable for "call-out service requested by the customer or service necessitated by the customer's negligence." The After Hours Call-Out charge would not be applied to after hours service calls for situations such as system low pressure, water quality issues, water main breaks or other system malfunctions. (ACUC-LWUC Ex. 5.0, p. 4). Following Company witness Daniel's clarifications in rebuttal testimony, Staff witnesses Boggs did not object and recommend approving the After Hours Call-Out charges.

3. Temporary Disconnection Charge

Companies' witness Burris proposed that the Companies increase their Temporary Disconnection charge to \$37.50 so that it could recover the current average cost of labor for one hour of employee time to provide these services. (AC Ex. 2.0, p. 14, LW Ex. 2.0, p. 14). In response to Staff DR CB 1.07, the Companies provided an average labor cost for hourly customer service labor, hourly field staff labor and mileage to disconnect/reconnect a customer. Based on a review of the data provided by the Companies, Staff witnesses Boggs and Rukosuev determined that the proposed increase is reasonable and recommend the increase be approved. (Staff Ex. 5.0, p. 10 and Staff Ex. 4.0, p.14).

4. Reconnection Charge

The Companies proposed to increase their reconnection charge from \$20 to \$37.50. In its direct testimony, the Companies stated that it would like to recover the

current average cost of labor for one hour of employee time to provide the reconnection service. (AC Ex. 2.0, p. 14, LW Ex. 2.0, p. 14). In response to Staff DR CB 1.07, the Companies provided average labor costs for hourly customer service staff, hourly field staff, and mileage to support the proposed increase. Based on a review of the data provided by the Companies, Staff witnesses Boggs and Rukosuev determined that the proposed increase is reasonable and recommend the increase be approved. (Staff Ex. 5.0, p. 10 and Staff Ex. 4.0, p.13).

5. Non Sufficient Funds Charge

The Companies proposed to increase the Non-Sufficient Funds (NSF) Check charge from \$10 to \$25. (AC Ex. 2.0, p. 13, LW Ex. 2.0, p. 13). In direct testimony, Staff witnesses Boggs and Rukosuev stated that, based on the information provided, the \$25 NSF charge proposed by the Company is reasonable and should be approved. (Staff Ex. 5.0, p.9 and Staff Ex. 4.0, p. 11).

6. New Service Application Fee

The Companies proposed to reserve the right to assess a minimum fee of \$50 for a new service application, if deemed necessary due to applicant's undesirable credit history. (AC Ex. 2.0, p. 14, LW Ex. 2.0, p. 14). In direct testimony, Staff witnesses Boggs and Rukosuev recommended rejecting the fee and stated that the tariff language setting forth this fee must be compliant with 83 Illinois Administrative Code Part 280.50, 280.60, and 280.70. Staff recommended that the Companies provide updated tariff language which complies with the Illinois Administrative Code in their rebuttal testimony. (Staff Ex. 5.0, p.14 and Staff Ex. 4.0, p. 17-18).

Although the Companies did not provide updated tariff language with their rebuttal testimony, Companies' witness Mr. Daniel stated that the Companies would abide by the Commission's rules. (ACUC-LWUC Ex. 5.0, p. 3). In rebuttal testimony, Staff pointed out that the Companies' Rules, Regulations and Conditions of Service, ILL. C.C. 96 No. 1, Original Sheet 22, paragraph 16 titled "Customer's Deposit," currently provides the appropriate verbiage that allows the Company to assess a deposit. Staff stated that "[t]he Company's initial proposal to assess a minimum security deposit of \$50 should not be approved. Instead, the Company should continue to use its current Rules, Regulations and Conditions of Service (ILL. C.C. No. 1 Original Sheet 22 paragraph 16) when assessing the need for a customer deposit." (Staff Ex. 10.0, p. 5 and Staff Ex. 11.0, p.5).

B. COMMISSION ANALYSIS AND CONCLUSIONS

The Companies have presented their proposed rates and Staff has accepted some proposals, but also has proposed changes in other areas. The Companies have accepted Staff's revisions on rate design matters.

Staff notes that the proposed tariff sheets the Companies submitted as Exhibit A to its Initial Brief reflect the rate design that has been agreed upon by Staff witnesses

Boggs and Rukosuev and the Companies. However, the rates reflected on Exhibit A conform to the revenue requirements the Companies are advocating. Staff states that Boggs and Rukosuev proposed rates in their direct and rebuttal testimonies based upon Staff's proposed revenue requirements. Thus, the rates are not agreed upon.

The Commission concludes that inasmuch as the Companies have stated in both their Initial and Reply Briefs that Operation and Maintenance expenses is the one single unresolved issue with Staff, the Companies are in fact adopting Boggs and Rukosuev's proposed rates in their direct and rebuttal testimonies based upon Staff's proposed revenue requirements.

Staff also mentions that the tariff sheets submitted as Exhibit A reflect a \$25 fee for the New Customer Charge. The Companies' current tariffs reflect a \$15 New Customer Charge and the Companies did not propose a change to the New Customer Charge in its filing or testimony. Staff maintains that the Companies' tariffs should continue to reflect a \$15 New Customer Charge. We agree with Staff on this issue as well.

VI. MISCELLANEOUS - UNCONTESTED

In the course of these proceedings, Staff and the Companies raised several additional miscellaneous issues.

A. RULES CHANGES

Apple Canyon proposes several changes to its Rules. (AC Ex. 2, pp. 15-18). Smith opposed all rules changes. (Staff Ex. 6.0, pp. 3-9). The Company withdrew its request for all changes. (ACUC-LWUC Ex. 5.0, p. 5).

B. UNAUTHORIZED SERVICE

In direct testimony, Staff addressed the provision of unauthorized service by Lake Wildwood. (Staff Ex. 6.0, p. 10). The Company has filed a petition addressing the problem, Docket No. 10-0224. (ACUC-LWUC Ex. 5.0, pp. 5-6). There is no issue on this point.

C. AGED METERS

In direct testimony Staff addressed the problem of aged meters. (Staff Ex. 6.0, p. 11). The Companies indicated in rebuttal testimony that they have a plan in place to replace aged meters. (ACUC-LWUC Ex. 5.0, p. 6). There is no issue on this point.

VII. FINDINGS AND ORDERING PARAGRAPHS

The Commission, having considered the entire record herein and being fully advised in the premises, is of the opinion and finds that:

- (1) Apple Canyon Utility Company and Lake Wildwood Utilities Corporation provide water service to the public within the State of Illinois, and, as such, are “public utilities” within the meaning of the Public Utilities Act;
- (2) the Commission has jurisdiction over Apple Canyon Utility Company and Lake Wildwood Utilities Corporation and of the subject-matter herein;
- (3) the recital of facts and conclusions reached in the prefatory portion of this Order are supported by the evidence, and are hereby adopted as findings of fact;
- (4) a test year ending December 31, 2008, should be adopted for the purpose of this rate proceeding;
- (5) for the test year ending December 31, 2008, and for the purposes of this proceeding, the rate base for Apple Canyon Utility Company and Lake Wildwood Utilities Corporation is as follows:

Apple Canyon Utility Company: \$783,003;

Lake Wildwood Utilities Corporation: \$778,092;

- (6) a fair and reasonable rate of return on the rate base for Apple Canyon Utility Company and Lake Wildwood Utilities Corporation is 8.49%; rates should be set to allow the Companies an opportunity to earn that rate of return on its rate base, as is determined herein;
- (7) the rates which are presently in effect for Apple Canyon Utility Company and Lake Wildwood Utilities Corporation, which are presently in effect, are insufficient to generate the operating income necessary to permit these Companies to earn a fair and reasonable rate of return; those rates should be permanently canceled and annulled as of the effective date of the new tariffs allowed by this Order;
- (8) the rates proposed by Apple Canyon Utility Company and Lake Wildwood Utilities Corporation would produce a rate of return in excess of a return that is fair and reasonable; the Proposed Tariffs of Apple Canyon Utility Company and Lake Wildwood Utilities Corporation should be permanently canceled and annulled;
- (9) Apple Canyon Utility Company and Lake Wildwood Utilities Corporation should be permitted to file new tariff sheets setting forth the rates designed to produce operating revenues as follows:

Apple Canyon Utility Company: \$459,047;

Lake Wildwood Utilities Corporation: \$308,961;

as such revenues are necessary to provide the Companies a rate of return of 7.79% on their rate base, consistent with the findings herein; these tariff sheets shall be applicable to service furnished on or after their effective date;

- (10) the new tariff sheets to be filed pursuant to finding (9) above, shall reflect an effective date not less than five (5) business days after the date of filing, with the tariff sheets to be corrected within that time period if necessary;
- (11) the proposed Rules, Regulations, and Conditions of Service tariffs proffered by Apple Canyon Utility Company and Lake Wildwood Utilities Corporation are approved;
- (12) all remaining motions, petitions, objections, or other matters in this proceeding should be disposed of in a manner consistent with the conclusions reached herein;
- (13) Apple Canyon Utility Company and Lake Wildwood Utilities Corporation must establish and maintain continuing property records in compliance with the Commission's rules; these Companies must also file a report with the Manager of the Commission's Accounting Department. Such report shall evidences successful implementation of the continuing property record program within 12 months after the final order in this proceeding; and
- (14) Apple Canyon Utility Company and Lake Wildwood Utilities Corporation shall otherwise perform all actions that this Order requires of it.

IT IS THEREFORE ORDERED by the Commission that the tariff sheets proposing a general increase in water rates filed by Apple Canyon Utility Company and Lake Wildwood Utilities Corporation on October 14, 2009 are hereby permanently canceled and annulled.

IT IS FURTHER ORDERED that Apple Canyon Utility Company and Lake Wildwood Utilities Corporation are authorized to place into effect tariff sheets which will produce the annual operating revenues and operating incomes set forth in Finding (9) above, and are consistent with Appendices A and B to this Order, to be effective on the date of filing for water service furnished on and after such effective date.

IT IS FURTHER ORDERED that Apple Canyon Utility Company and Lake Wildwood Utilities Corporation must file their Rates, Rules, Regulations, and Conditions

of Service tariffs, within ten (10) days of the Order, with an effective date of not less than ten (10) business days after the date of filing, for service rendered on and after their effective date, with individual tariff sheets to be corrected within that time period, if necessary.

IT IS FURTHER ORDERED that upon the effective date of the tariff sheets filed pursuant to this Order, the presently effective tariff sheets of Apple Canyon Utility Company and Lake Wildwood Utilities Corporation, which are replaced thereby are permanently cancelled and annulled.

IT IS FURTHER ORDERED that any petitions, objections or motions made in this proceeding and not otherwise specifically disposed of herein are hereby disposed of in a manner consistent with the conclusions contained herein.

IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code 200.880, this Order is final; it is not subject to the Administrative Review Law.

DATED:
BRIEFS ON EXCEPTIONS DUE:
REPLY BRIEFS ON EXCEPTIONS DUE:

July 21, 2010
August 6, 2010
August 13, 2010.

D. Ethan Kimbrel
Administrative Law Judge